

CHOICE IN CONTEXT: RATIONALITY, CONTINGENCY AND RISK IN THE DIVIDEND POLICY

Narcis Tulbure

narcis.tulbure@fin.ase.ro

Bucharest University of Economic Studies, Romania

This paper is a critical review of the recent literature regarding the dividend policy with regards to the different conceptualizations of rationality demonstrated by managers of companies or individual investors. This approach gives us the opportunity to reassess the latest contributions to dividend policy analysis and to adopt an alternative perspective to those of authors that have split the literature on dividends in the normative vs. descriptive approaches, empirical vs. theoretical contributions, according to the distinct paradigms various approaches illustrate, or according to chronological criteria. We surmise that the issue of rationality / irrationality occasions a better understanding of the latest contributions to corporate finance from the subfields of behavioral finance and of cultural finance. Such contributions challenge the premises of rational choice, one that is foundational for the neoclassic paradigm. Behavioral corporate finance and cultural corporate finance underline the role of psychological and socio-cultural factors for the dividend policy. They facilitate the emergence of notions of situated / contingent rationality considered responsible for the diverse shapes taken by the financial policies of the corporation.

Keywords: Rationality, dividend policy, culture and finance

JEL Code: B4, G02, G35

1. Introduction

This paper traces the parallel development of the literatures on cultural finance (CF) and on behavioral corporate finance (BCF) to document some of the most recent challenges to the classical theories in corporate finance. It focuses specifically on the distinct conceptualizations of the rationality of investors and managers of companies and seen especially into the cross-cultural variability in the attitudes toward risk manifest in the dividend policy of the corporation. I hold that the issue of rationality / irrationality occasions a better understanding of the latest contributions to corporate finance from the subfields of behavioral finance and of cultural finance. Such contributions challenge the premises of rational choice, one that is foundational for the neoclassic paradigm. Behavioral corporate finance and cultural corporate finance underline the role of psychological and socio-cultural factors for the dividend policy. They facilitate the emergence of notions of situated / contingent rationality considered responsible for the diverse shapes taken by the financial policies of the corporation.

Contributions to the already consolidated field of behavioral corporate finance (Baker and Wurgler, 2011; Breuer, Rieger and Soypak, 2014) have generally brought attention and tried to formalize the limits of rationality shown simultaneously by investors and the managers of public companies. Some have suggested a more radical break with the rational choice paradigm by emphasizing the outright irrational behavior of investors. A more recent stream of research, usually gathered under the heading of “cultural finance” or “culture and finance” (Breuer and Quinten, 2009; Reuter, 2011a, 2011b) has adopted a critical stance not only towards classical finance and its rigid notion of rationality but also towards behavioral corporate finance. BCF had not only replaced the mathematical determinism of neoclassic finance with a similar universalism of psychological nature - critics of the paradigm from cultural finance hold, but has insisted on the limits of rationality and has often defended the hypothesis of irrationality. Innovators in the field of corporate finance claim to be able to test the hypotheses of corporate finance in more encompassing cross-cultural settings as well as to relax and contextualize (but not to repudiate altogether) the idea of rationality assumingly driving economic behavior.

The recently growing culturalist trend in corporate finance reevaluates but also adds to the developments brought by approaches based on behavioral finance during the latest two or three

decades. Such cultural approaches emphasize socio-cultural characteristics, religious doctrines and ethno-national configurations of values as complementary, overlapping, yet more profound factors shaping financial behaviors than the psychological, institutional, legal, or developmental characteristics underlined by the institutional or behavioral subfields in finance. Such factors shape equally the behaviors of individual investors and executives and can be measured / studied through a focus on the financial policies of the company. In spite of the distinct epistemological tradition and of the competition among economists pursuing these approaches, the ultimate contribution of the growing fields of CF and BCF is a conception of situated / contingent rationality that is able to account for the cross-cultural variability of the financial policies of the corporation.

The paper has the following structure: the first section makes an introduction to the overlapping research foci of "culture and finance" and "behavioral corporate finance" describing briefly the contributions both of them promise to make to the established field of corporate finance. Particular attention is paid to the way such competing challenges to classical corporate finance conceptualize the rationality of investors and managers. Section three introduces some diverse notions of rationality and the ways the concept has shifted historically. The following section focuses attention on two types of approaches contributed by each of the emerging subfields. The two approaches propose contrasting but ultimately illustrate similar efforts to integrated economic, institutional, behavioral and cultural variables in the same analytic framework. Such integrative effort not only contribute but are themselves premised on more nuanced conceptions of rationality than those of neoclassical economics. The conclusion is a plea for embarking on the shift of paradigm envisioned by both cultural finance and behavioural corporate finance. The ultimate contribution of the two growing fields is a conception of situated / contingent rationality that is able to account for the cross-cultural variability of the financial policies of the corporation.

2. Rationality and dividend policy

As the publications on the dividend policies implemented by companies across the world has grown beyond easy mastery during the last decades, the efforts to structure previous streams in the literature and to make sense of the existing contributions becomes of key importance. Not only are new approaches to the preference for dividends or to the dividend distribution decision many times contradictory and premised on contrasting epistemological foundations, but any new contribution to this topic can only be judged in connection to the existing results and perspectives. Previous reviews group the dividend policy literature chronologically, paradigmatically / theoretically (rational choice, information asymmetries, agency theories, behavioral models, culturalist approaches, etc.), into deductive vs. empirical approaches, or into normative vs. explanatory models. In his introduction to the book-length analysis of the dividend policies implemented by Romanian companies during the postsocialist period, Victor Dragotă (2003) adopts many of the above classifications. The classical normative approaches to dividends (assuming the rational choice of both investors and managers) as well as the "irrelevance principle" are unavoidable references so Gordon and Shapiro's arguments about increasing dividends as a premise for the valuation of the company (1956), Walter's treatment of dividends as a residual variable to the capital budgeting process (1956), or Miller and Modigliani's insistence on the irrelevance of the dividend policy (1961) are the starting point for most of the review of the fields. But so are the (by now) equally well established empirical approaches that, at least from the perspective of this paper, are some of the first deconstructions of the rational choice tenets of dividend policy theories: Lintner's model of dividends based on the initial level and a rate of adjustment towards the reference level (1956) – a remarkable contribution based on the survey of company managers during a period when deductive models were the epitome of scientificity, Stiglitz's insistence on the paradox of dividends, the persistence of which implies either the irrationality of investors or the presence of other goals than the neoclassic maximization of company value (1981), or La Porta et al.'s claim that dividends mitigate the agency problems inside the company (2000). Although V. Dragotă and Stoian (2006) deal with the issue of rationality manifest on the Romanian capital market by comparatively reviewing diverse tests of efficiency, later articles dedicated to dividend policy (such as, V. Dragotă [2006] or M. Dragotă et al. [2009]) do not insist on this topic but rather focus on the testing of some of the well-known theories on the capital market.

I choose to focus on the issue of rationality. More specifically, I consider that, beyond the methodological and empirical contribution, the recent advancements in behavioral corporate finance and cultural finance stimulate a much needed re-conceptualization of the types of (i)rationality manifest in financial choices and policies. This continues some of the earlier concerns of people modelling agency problems, information asymmetries, or institutional factors in order to loosen the

tenets of neoclassical theories in corporate finance, but makes the challenge to the earlier notions of economic rationality more explicit and radical. It also reflects paradigmatic shifts manifest simultaneously throughout a diverse range of subfields in economics and finance. As Tyler Cowen (2004) shows, the conception of rationality with which various branches of economics and finance has been premised on different ideas and has shifted in time, successive notions of rationality rooted in distinct disciplines displacing each other as the dominant concept of particular periods. Thus, while theories of consumer behavior under certainty emphasize the tautological definition of rationality, theories of consumer behavior under uncertainty view rationality as a set of testable hypotheses. While macroeconomics facilitated the growth of rational expectations theories, in finance rationality is linked with the efficient markets hypothesis. While game theory and computational economics pay a lot of attention to the concept of rationality and its operationalization, fields like empirical labor economics and experimental economics do not give it similar attention. More substantial reconceptualization of rationality have been fostered either in behavioral economics – where the notion of "satisficing" has undermined the claim to maximization inherent to most theories of rationality, or in philosophy and the social sciences – where ideas of "practical reason," "procedural rationality," or "expressive rationality" broaden economists' conception of rational decision making. In order to present my own approach to the issue of rationality in culture and finance, I adopt Simonson and Tversky's notion of "choice in context" (1992) which I treat (more broadly than they define it) as a conceptual metaphor focusing attention on the socio-cultural situatedness of dividend decisions and policies.

3. The parallel growth of cultural finance and behavioral corporate finance. Competing notions of rationality

The recently emerging subfield of cultural finance (Breuer and Quinten, 2009; Greif, 1994; Reuter 2011a, 2011b; Williamson, 2010) has in some ways contested the results contributed earlier by behavioral finance (Baker and Wurgler, 2011; Baker and Wurgler, 2012) but has in many ways continued the foundational critique of the classical models premised on rational choice that have been constitutive of modern finance. In the field of corporate finance, for instance, reviewers of the contributions of culturalist and behavioral approaches to the financial policies of the company are rather optimistic about the potential overlaps and hybridizations between the two rather "heterodox" approaches. Culture and psychological factors are complementary and overlapping, Oliver Williamson shows in his conceptualization of the multiple layers of culture (Williamson, 2000). In his view, culture is the most profound (and also the most difficult to measure) of the behavioral layers shaping financial choices; societal ethos and cultural values filter through institutions, government policies and contractual agreements to the level of the financial decisions made by the economic agents. Such a perspective, however, makes it necessary to interrogate the universalistic assumptions made by classical rational choice theories with regards to the dimensions of financial decisions.

One way to account for the cross-cultural variability of financial behaviors is to integrate cultural constraints into the existing "principle-agent models" elaborated in microeconomics. Such an approach would create the premises not only for fresh contributions to corporate finance but also for the integration of the culturalist and behavioral approaches that have appeared lately (Breuer and Quinten, 2009). Although the regular conceptualizations of culture as a set of traces and values characterizing various ethno-national groups around the world - contributed by the dimensionalist approaches in management studies and in the literature on economic growth (see Reuter 2011a for a description of the dimensionalist approaches of Geert Hofstede and Shalom Schwartz), do not bring spectacular results, other paradigms are slowly emerging. Thus is the approach proposed by Charles Reuter (2011b) consisting of the backward reconstruction of the set of cultural values and dispositions possessed by the group of economic actors that show a particular type of financial behavior. This approach avoids the trap of cultural essentialism (often criticized in contemporary anthropology and sociology) and facilitates contingent forms of rationality. These are, however, structured contingencies that seems to give consistency and recurrence to financial choices. While not discarding altogether the notion of rationality, these approaches, nevertheless invite the audience to consider the existence of a multitude of *homines culturales* instead of a universal type of choice-making and utility-maximizing actor.

Of the two approaches reviewed by this paper, behavioral corporate finance has appeared earlier and has managed to consolidate further into a quasi-autonomous subfield of corporate finance. Various review articles are able already to create typologies within the growing number of behavioral corporate contributions (Baker and Wurgler, 2011, 2012). Thus, behavioral economists had initially

focused on what they perceived as non-rational or even irrational decisions made by investors on the capital market. Either too enthusiastic or too apprehensive about the securities traded on the capital market, such erratic investors could be taken advantage of by the more rational managers of companies. Later contributions to the field tried to pay equal attention to the limits of rationality demonstrated by the decisions of managers who, from a behavioral perspective, often show overconfidence and hubris and thus an inability to act rationally in the interest of maximizing shareholder value. The most sophisticated contribution to behavioral corporate finance, however, are those considering the interactions between irrational investors and quasi-rational managers within the same analytical and mathematical framework (see, for instance, the "behavioral signaling model" proposed by Baker and Wurgler, 2012).

More recently, culturalist approaches initially elaborated in anthropology, sociology, or political science applied in other fields of economics were imported into finance. They promise to elucidate the cross-national variability of corporate financial policies and behaviors and to offer better explanations for the contrasting practices of investing, financing and cash-flow distributing across the world (Breuer and Quinten, 2009; Reuter, 2011a). Although saluted by many looking for fresh perspectives on corporate finance practices, more critical voices (Reuter, 2011b) argue that culturalist approaches will have a difficult integration into the field of finance given that they have been traditionally associated with conceptuality, with the study of values seen as the ends (rather than the means) of social (rather than economic) action, with qualitative rather than quantitative data and methods, as well as with description and meanings rather than analytic models.

Unavoidably, many see tensions and competitions between the two emerging approaches rather than fusions into more complex perspectives on reality. And whereas behavioral finance has managed to frame its critique of classical finance into more experimental and analytical models that are appropriate for econometric estimations, cultural finance is seen somewhat condescendingly for its over-reliance on descriptive and (unidimensional) empirical methodologies, the focus on problematic proxies for what are taken to represent fundamental cultural dimensions of behavior, and for the often problematic econometric estimations of models. With notable exceptions (see, for instance, the paper by Avner Grief, 1994), mathematical models of the empirical chains of causality linking cultural values with institutional arrangements and financial behaviors fail to emerge.

For the purposes of this paper, however, the distinct ways in which the two approaches treat the issue of rationality is rather more telling. Behavioral corporate finance approaches are concerned more with how reasoning and choice are influenced by context and depart from the classical tenets of economic rationality. At the same time, cultural finance investigates the particular notion of rationality that explains the way decisions are influenced by socio-cultural values. Although the behaviors investigated by both subfields seem to be at the margins of or even outside the sphere of rational choice, maybe paradoxically, behavioral finance makes a more radical deconstruction of the notion of rationality whereas culture and finance is suggesting forms of situated rationality. Thus, although less theoretical, cultural finance seems to be more malleable and looks at social / cultural / religious factors shaping and enabling behaviors rather than at how limited rationality is an obstacle to choices that maximize value. Given these drifting tendencies, a number of questions arise about the two competing approaches: are there hybridizations and collaborations possible in spite of the methodologically and theoretically distinct foundations? Will cultural approaches to finance be able to attain the analytic and theoretic rigor of studies in behavioral corporate finance? What is the understanding of rationality made possible by such hybrid approaches? The following section draws attention to two articles that illustrate well both the limitations of culturalist approaches and the potential of mixed perspectives for elucidating the variability of practices studied by corporate finance.

4. Culture, behavior, and rationality in corporate finance

4.1. Cross-cultural comparisons and their subtle view of rationality

The articles grouped under cultural finance do not generally deal with the issue of economic rationality in an overt way. Rather, as shown by the excellent review articles accounting for the field (Reuter, 2011a), the postulates of rational choice are implicitly relaxed when cross-sectional and comparative approaches to financial phenomena are implemented. A diversity of economic outcomes and processes are usually regressed on a more or less standardized set of cultural, social, educational, institutional, or macroeconomic values but these explanations do not usually make it into theoretical models.

Some of the most representative articles illustrating this cross-cultural comparative approach are Jana Fidrmuc and Marcus Jacob's analysis of the cross-national variability in the dividend policy implemented by companies (2010) and Sung Bae, Kiyong Chang, and Eun Kang's analysis of the combined role of cultural and institutional factors in shaping dividend distribution internationally (2012). Thus, drawing on the cultural dimensions proposed earlier by Geert Hofstede (but also those of Shalom Schwartz), Fidrmuc and Jacob prove that there is a cultural component in dividend policy at the international level. Behavioral factors are equally significant in shaping dividend distribution and, what seems to be particularly interesting, culture and behaviors are complementary rather than simply substitutable. They are regressed in a cross-section of almost six thousand companies selected from over forty countries around the world on cultural, behavioral, institutional and economic variables. The main cultural variables used in the analysis are Hofstede's cultural dimensions individualism vs. collectivism, the tolerance of power distance in society, and the level of uncertainty avoidance characterizing the discount between present and future outcomes. All of these variables exercise a significant influence on dividend distribution policies as countries scoring high on individualism, low on power distance and low on uncertainty avoidance are associated with high rates of dividends distributed to minority shareholders.

Similarly, the paper contributed by Bae, Chang, and Kang (2012) investigate the factors explaining the international variability in the dividend payout policies. Beyond the firm-level factors, the legal regime of the country and the quality of regulations in place, the authors investigate the influence of cultural factors characterizing the countries where companies are located. The main contribution of the articles is the analysis of the combined effects of culture and investors protection (institutional quality) on the dividend policy of various countries. The authors further contribute a broader database of companies, countries and years than those of similar articles, dependent variables measuring the level, change and propensity to pay dividends, as well as an analysis of the additional explanatory power of cultural factors when the effect of institutional factors is controlled. At a more general level, however, the article reconciles contrasting explanations of dividends: the "outcome model" suggesting that the level of dividends is directly dependent on the level of investor rights and the "substitute model" of dividends proposing, on the contrary, dividends tend to be higher in countries with low levels of protection for minority shareholders as a way to mitigate the agency problems. In this context, culture appears as the deeper configuration of values whose external manifestations can generate various information asymmetries and agency problems within companies. What appear as non-rational dividend levels or as departures from the classical theories of dividends may recapture coherence and rationality when situated in the cultural and institutional context where they are observed.

These studies suffer from a number of limitations, the most important of which being due to the fact that, in lack of a formal model, the translatability of the framework of analysis to other context and times is limited. The lack of a mathematical model and of economic formalism however, is compensated by the intuitiveness, clarity of hypotheses and conclusions and of the sound empirical foundations. Rationality is not criticized abruptly but rather the tenets of classical theories of dividends come out more nuanced in light of the sound evidence for the cross-cultural variations in dividends. However, other authors have shown that it is possible to take the culturalist approach one step further by supporting it with an analytical framework that stands the test of empirical evidence.

4.2. Cultural and behavioral complementarities: toward a model of situated rationality?

Culturalist approaches to finance have lately gone beyond the strictly empirical with the addition of formalization and mathematical modelling. Such is the case of a recent article contributed by Wolfgang Breuer, Oliver Rieger and Can Soypak (2014) on the behavioral foundations of dividend policy. "Behavioral" is a nametag for a broader category of factors as both the psychological processes analyzed by behavioral finance and the cultural variables recently added to the study of financial process are integrated into a common framework. In this framework, loss aversion, ambiguity aversion, and the level of time discounting are part of a mental accounting model that explains the dividend payout policy in a cross-national setting.

Thus, Breuer et al. elaborate a dynamic model considering a dividend to be paid during the first period – on which the utility from the current income account is premised, the residual value of the company after the dividend is paid – the source of the current assets account utility, and the result of investing the residual value of the company to the second period – the source of the utility generating future income account. All the components are mentally allocated into the current income

account, the current assets account, and the future income account by a behavioral finance type of agent.

Companies have to set the value of the first-period dividend so as to maximize the aggregate utility from the three sources mentioned above. All functions modelling the three types of utility have the (by now) classical Prospect Theory shape:

$$u(x_t - x_t^{(R)}) = \begin{cases} (x_t - x_t^{(R)}) \cdot \alpha^+ \\ -\lambda \cdot (x_t^{(R)} - x_t) \cdot \alpha^- \end{cases}$$

and β , δ , and λ are parameters for patience, ambiguity aversion, and loss aversion.

The analytic solutions derived for this mental accounts model are turned into research hypotheses to be tested econometrically in a cross-sectional environment proving that, while patience leads to the acceptance of lower dividends, loss aversion and uncertainty aversion seem increase the expected level of dividends.

Variables measuring dividends scaled by earnings, sales and operating cash-flows are explained by behavioral, cultural, institutional and economic factors. Initially, the shape of the dividend policy is explained by data on the subjective preference parameters from the international test of risk attitudes (INTRA) survey carried out among economics students in 46 countries. Additionally, variables coding for cultural values (taken from Geert Hofstede and Shalom Schwartz) are included in the model. Although found to be sometimes redundant and sometimes complementary to the behavioural ones, cultural variables are nevertheless significant and fit with the theoretical model elaborated initially.

This article thus shows that cultural variables are not only complementary to behavioral one, but can actually be accommodated by models derived from behavioral finance. This not only gives culturalist approaches sounder theoretical underpinning, but nuances the previous contestation of the concept of economic rationality done from the perspective of behavioral studies. Such an approach can set the foundations for theoretically grounded models of situated rationality. It manages to not only situate choices related to the dividend policy in a model based on the prospect theory utility function and on mental accounting – both key approaches in behavioral finance, but also to allow for the cross-national variability in the shape of these functions (hence, in the dividend policy) through the inclusion of cultural variables and of the results of a trans-national survey of psychological attitudes to risk. Culture seems to be a more resilient level of the reality, one that, nevertheless, shapes both institutions and psychological behaviors and choices. As a consequence, what appears as inconsistent or erratic individual behaviors, get a specific regularity once embedded in wider configurations of values and thought characterizing cultures across the world.

5. Conclusion

This paper has focused on the issue of rationality as reformulated by the intersecting fields of cultural finance and of behavioral corporate finance. Emerging over the last decades, these fields challenge the tenets of (neoclassical-grounded) discipline of corporate finance and its thesis of economic rationality based on the utility maximization of investors and/or managers. Although the two subfields have generated hybrid approaches at times, insightful critiques of the classical tenets of corporate finance, the fusion of the two approaches happens with difficulty and great effort. To blame is that fact that the two subfields generally elaborate on quite distinct epistemological foundations, use different methodologies and sources of data, and operate with rather distinct notions of rationality, risk, or utility. While approaches in cultural finance are generally empirical and based on cross-national comparisons, contributions to behavioral corporate finance use experiments to illustrate the irrationalities in agents' behavior.

The two types of approaches that were presented more in depth in here demonstrated some of the limitations of the current contributions in cultural finance to the comparative analysis of the financial policies of the corporation and the rationality of investors and / or managers. At the same time, they also demonstrate some very promising avenues for building a theory of situated / contingent rationality based on empirical research. Thus, the articles by Jana Fidrmuc and Markus Jacob (2010) and by Sung Bae, Kiyoun Chang, and Eun Kang (2012) implement the dimensional framework of analysis initiated by Geert Hofstede and refined by Shalom Schwartz to produce a cross-cultural analysis of the dividend policy. Such contributions have a pronounced empirical character, do not conceptualize rationality in an equally systematic manner as either the well-established paradigm in corporate finance or as the more recent contestations of the neoclassical tenets from the field of

behavioral finance, and find it difficult to claim a clear theoretical identity (one notices overlaps with comparative quantitative approaches in sociology, political science, management and accounting). The second approach to which extensive attention was paid above, written by Wolfgang Breuer, Oliver Rieger, and Can Soypak (2014), suggest a promising avenue, however, integrating cross-cultural variable into a behavioral corporate finance model that can be tested trans-nationally. A theoretically driven article offering analytic solutions to the equations specified initially that are tested econometrically, the article builds on behavioral models that are finally drawn into a cross-cultural comparison based on cross-sectional regression.

The recent developments in "cultural finance," "culture and finance," or "behavioral corporate finance" contribute several directions for the renewal of the well-established fields of finance and corporate finance. Although many see these emerging subfields as dominated by relations of competition and tension, as the above review of some of their contributions has shown, there are numerous areas of overlap, complementarity and potential for collaboration. While the main contribution of all of these areas is to get corporate finance "outside of the box," that is, to make it sensitive to factors of influence and processes outside of the narrow conception of the "economic", their methodological, theoretical, and empirical propositions are multiple. Thus, such emerging subfields make use of new data (derived to a large extent from surveys and experimental research), implement more flexible models (integrating previous results from behavioral finance / economics), privilege econometrics techniques specific to panel data and qualitative variables (use widely in comparative social sciences such as sociology, political science, or accounting), and are empirically rather than theoretically driven. All of the above contributions noted, one of the main significant additions to the neoclassical paradigm in corporate finance is the critique of the notion of (economic) rationality. I argue that, noting the distinctions between an emphasis on irrationality in behavioral finance and the laxer (more inclusive) notions of rationality in cultural finance, the increased conversation between authors in these emerging subfields could foster a paradigm of situated/contingent rationality, one in which the choices of investors and managers are put in context, modeled, and tested econometrically in a cross-national context.

Acknowledgement

„This paper was co-financed from the European Social Fund, through the Sectorial Operational Programme Human Resources Development 2007-2013, project number POSDRU/159/1.5/S/138907 "Excellence in scientific interdisciplinary research, doctoral and postdoctoral, in the economic, social and medical fields -EXCELIS", coordinator The Bucharest University of Economic Studies”.

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